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11. Report on the Renegotiation Act of 1951 (H. Doc. 322)

12. Cross-References within the Internal Revenue Code of 1954 as of Jan. 1, 1962

13. Summary of the Revenue Bill of 1962 As It Passed the House (H.R. 10650)

14. Digest of Testimony Presented and Statements Submitted to the Committee on Finance with Respect to H. R. 10650

15. (Conf.) Supplemental Digest of Testimony Presented and Statements Submitted to the Committee on Finance with Respect to Foreign Income Tax Sections of H. R. 10650

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17. (Conf.) Suggestions for Amendments to H. R. 10650

18. Summary of Revenue Bill of 1962 As Reported by the Senate Committee on Finance (H. R. 10650)

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SUMMARY OF THE PROVISIONS OF THE SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1962

H.R. 10, 87TH CONGRESS, PUBLIC LAW 87–792

PREPARED BY THE

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SUMMARY OF THE PROVISIONS OF THE SELF-EMPLOYED INDIVIDUALS TAX RETIREMENT ACT OF 1962

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The Self-Employed Individuals Tax Retirement Act of 1962 treats self-employed individuals as employees of the business which they conduct so that they may be covered under qualified employee retirement plans in much the same manner as their employees (secs. 401(c)(1), 401(c)(4)).* By permitting them to be covered, a portion of the amount contributed under the plan for their benefit (generally, one-half) may be deducted currently. Retirement benefits when paid to individuals as annuities under qualified plans would be taxable as ordinary income. However, contributions which were not deductible may be recovered free of top (sec. 72(d)(2)).

Generally, any individual who has net earnings from self-employment (and thus is liable for the tax on self-employment income) is made eligible for qualified retirement plan coverage. The fact that an individual may be an employee who is covered under a retirement plan established by his employer will not prevent him from participating in another plan as a self-employed individual if he has net earnings from self-employment. Special provisions in the new statute permit doctors and ministers as well as certain people who perform services for compensation in their own homes and commissioned salesmen (other than full-time life insurance salesmen who are treated under present law as employees for pension purposes) to participate even though they do not have net earnings from self-employment within the meaning of section 1402 of the Internal Revenue Code (sec. 401(c)(2)). Self-employed individuals who own 10 percent or less (of the capital or profits) of a trade or business conducted as a partnership automatically would be covered under a qualified employee retirement plan whether or not they give their consent, but owner-employees—that is, self-employed individuals who own more than a 10-percent interest in the trade or business—would be covered only if they give consent (sec. 401(d)(4)).

By treating self-employed individuals as employees under retirement plans, there are brought into play (although with material modification) most of the statutory and administrative rules presently applicable to such plans. For example, if the plan covers self-employed individuals, none of whom are owner-employees, limitations are imposed by the new law on the amounts which may be deducted as contributions for them, but the discriminatory and other requirements of existing law will otherwise apply to the plan. However, if a retirement plan covers an owner-employee, special rules (sec. 401(d)) govern the amount which may be contributed for him as well as the

*Section references in this summary are to new provisions added to the Internal Revenue Code of 1954 by the Self-Employed Individuals Tax Retirement Act of 1962.

portion of the contribution which may be deducted for Federal income tax purposes. In addition, there are new requirements with respect to coverage of his employees and contributions for them.

This new law will apply to taxable years beginning after December 31, 1962.

Contributions and deductions

Self-employed individuals who are owner-employees may contribute up to 10 percent of their earned income or $2,500, whichever is less, under a qualified plan (secs. 401(d)(5), 404(e)). Other self-employed individuals—that is, those who own 10 percent or less of their trade or business—are not restricted by these limitations but may contribute greater amounts for themselves provided such larger contributions are in accordance with a nondiscriminatory plan. However, only one-half of the amount, up to the lesser of 10 percent of earned income or $2,500, which any self-employed individual contributes for his own benefit is deductible for Federal income tax purposes (sec. 404(a)(10)). Thus, in no event may the deductible amount exceed $1,250. Under the new statute, these contributions are deductible from gross income. This means a self-employed individual may obtain the benefit of this deduction even if he elects to compute his income tax by taking the standard deduction.

The following examples illustrate the application of these limitations in the case of a self-employed person who is not an owner-employee:

(1) A owns a 10-percent interest in a partnership in which only personal services are a material income-producing factor. He derives earned income of $30,000 a year from the partnership. The partnership has established a qualified retirement plan which calls for nonforfeitable contributions for employees of 10 percent of their salary and contributions for owner-employees and other self-employed individuals of 10 percent of their earned income. The partnership contributes for A $3,000 under the plan (10 percent of $30,000). A deducts $1,250 (50 percent of 2,500).

(2) B owns a 10-percent interest in a partnership in which both capital and personal services are material income-producing factors. His income from the partnership amounts to $30,000. His earned income is $9,000 (30 percent of $30,000). The partnership establishes a qualified retirement plan which calls for nonforfeitable contributions for employees of 15 percent of their salary and contributions for self-employed individuals who are not owner-employees of 15 percent of their earned income. The partnership contributes for B $1,350 under the retirement plan (15 percent of $9,000) and B deducts $450 (one-half of the lesser of $2,500 or 10 percent of earned income).

The following examples illustrate the application of these limitations in the case of an owner-employee:

Example 1: A commission salesman has earned income of $23,000. He has no employees. Under the bill he establishes a qualified retirement plan under which he will be the only beneficiary. The plan calls for contributions of 10 percent of earned income. The salesman contributes to the plan $2,300 (10 percent of $23,000). Of this amount he may deduct one half, or $1,150.

Example 2: A real estate broker with four full-time employees has earned income of $30,000 from commission selling. He anticipates that it will continue at or above that level. All employees have more than 3 years' service. Two of the employees earn $4,000 each, the

other two earn $10,000 each. He establishes a qualified retirement plan which calls for nonforfeitable contributions for each employee who has more than 3 years' service of 10 percent of his earnings and for contributions for owner-employees of 10 percent of earned income. Thus, for his employees, the owner-employee would contribute, and deduct, $2,800 (10 percent of $28,000). And, for himself, he would contribute $2,500 (the lesser of $2,500 or 10 percent of $30,000). Of this amount, he would deduct $1,250.

If, under the circumstances described above, the real estate broker had established a plan calling for that contribution percentage which, when applied to his earned income would ordinarily produce the maximum contribution for himself at the lowest cost, the plan would call for nonforfeitable contributions for himself and for each employee of 8⅓ percent of earnings. Thus, for his employees, the owner-employee would contribute, and deduct, $2,333 (8⅓ percent of $28,000). And, for himself, he would contribute $2,500 (the lesser of $2,500 or 8⅓ percent of $30,000) and deduct $1,250.

Retirement plans permitting or requiring additional contributions by employees, as well as those to which the employer alone makes contributions, may be established by an owner-employee only if he has employees (sec. 404(e)). If employees who are not owner-employees are permitted to make nondeductible contributions to the plan, the owner-employee also may make nondeductible contributions on his own behalf up to 10 percent of his earned income or $2,500, whichever is the lesser; however, the rate of such contributions must not exceed the rate permitted for employees. In no event may such contributions by an owner-employee exceed $2,500. Such contributions will not be deductible either by employees or by owner-employees, but must be made out of income that has already been taxed.

Earned income

The base for measuring contributions for self-employed individuals is "earned income," which is defined generally as net earnings from self-employment to the extent such net earnings are received as compensation for services actually rendered (secs. 401(a)(5), 401(c)(2), 404(a)(8)). Where both capital and personal services are material income-producing factors in the trade or business, however, not more than 30 percent of the net earnings of the taxpayer from the trade or business may qualify as earned income. An exception to this rule provides that if the net earnings of the taxpayer from the trade or business amount to $2,500 or less the entire amount is to be considered as earned income, and if these net earnings are between $2,500 and $8,333.33 then $2,500 is to be considered as earned income.

In determining how much of an individual's net earnings from self-employment constitutes "earned income," the entire amount received as professional fees or commissions is to be treated as earned income if the clients look to the self-employed individual as the person responsible for services rendered, even though the services actually may be rendered by employees.

The following illustrations indicate the determination of earned income in various situations:

1. A doctor has net profit of $40,000 from professional services. His patients look to him as the person responsible for the services rendered. The full amount of this net profit constitutes earned income.

2. A self-employed grocer has net profit of $40,000 from his wholly owned retail grocery business. Both capital and personal services are material income-producing factors. His earned income is $12,000 (30 percent of $40,000).

3. A gasoline service station operator has net profit from his wholly owned unincorporated service station of $2,400. Both capital and personal services are material income-producing factors. Under the bill, the entire amount of such net profit is deemed to be earned income since it does not exceed $2,500.

4. A contracting partnership composed of three partners who share equally in its profits has partnership net profit of $22,500. Both capital and personal services are material income-producing factors. Of the $7,500 attributable to each partner, $2,500 constitutes earned income (30 percent of $7,500, or $2,500 whichever is greater, where each partner's share of net profits exceeds $2,500).

5. A and B are partners in a stock brokerage firm. A supplies all necessary capital but performs no personal services. B has no capital interest, but performs all personal services required by the firm. They share profits equally. Both capital and personal services are material income-producing factors. The firm has net profit from brokerage commissions of $50,000 and total net profit from all sources of $70,000.

A has no earned income from the partnership since he performed no personal services.

B has earned income of $10,500 (30 percent of $35,000).

Coverage for employees

In order for an owner-employee to participate under a qualified employee retirement plan, the plan must provide that each full-time employee with more than 3 years of service be covered (sec. 401(d)(3). Moreover, contributions for covered employees must be fully vested (that is, benefits may not be dependent upon continued service or any other contingency) at the time they are made (sec. 401(d)(2). In applying these rules, all trades or businesses controlled by a self-employed person or by the same group of self-employed persons are required to be brought together and considered as one trade or business (secs. 401(d)(9), 401(d)(10)).

Time for paying benefits

A qualified plan must provide that benefits for a self-employed individual may not be payable to him prior to his attaining age 59½ (except in the case of his earlier death or disability) but must be payable to him, or pension payments must begin, not later than the taxable year in which he reaches age 70½ (secs. 401(a)(9), 401(d)(4). These benefits may be paid over the life of the self-employed individual or over his life and that of his spouse, or for a term certain not extending beyond his life expectancy or the joint life expectancy of him and his spouse. An individual is considered disabled under the new law if he is unable to engage in any substantial gainful activity because of a medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.

If, despite the requirements of the plan, amounts are withdrawn prematurely by a self-employed person, a tax penalty is imposed (sec. 72(m)). If the premature distribution amounts to $2,500 or

more, the tax imposed would not be less than 110 percent of the increase in tax that would have resulted if the income had been received ratably over the 5 years ending with the year of distribution. If the premature distribution amounts to less than $2,500, the tax due would be 110 percent of the increase in tax resulting from inclusion of the entire amount of the premature distribution in gross income for the current year.

Integration with social security

Retirement plans covering owner-employees may be integrated, or coordinated with social security under special rules provided by the new law. Under such integration, or coordination, the overall cost of a retirement plan might be materially reduced. Under present law as applied to qualified pension plans integration is permitted under rules which assume that the employer has paid for that portion of the social security benefit for which the employee himself has not paid.

Under this new law, if an owner-employee with employees establishes a retirement plan which meets the prescribed requirements and if allowable contributions (upon which the deduction is based) for owner-employees are not more than one-third of the total allowable contributions made under the plan, owner-employees, if they take into account the self-employment tax paid on their own behalf (or which would be paid except for the fact that such owner-employee is not covered by social security), may also take into account the employer portion of the FICA tax paid on behalf of covered employees. This method of coordinating such a pension plan and social security is different from the method permitted by Treasury rulings under the provisions of present law. Under this provision the owner-employee may take into account only the amount of social security taxes actually paid by him for his employees whereas the rules under present law, in effect, permit the employer to take into account social security benefits not attributable to employee taxes.

Method of funding

Qualified retirement plans covering self-employed individuals may be funded in a number of ways.

A. *Trust.*—There may be a trust. If the plan involves a trust, the trustee generally must be a bank (sec. 401(d)(1)). However, the self-employed individual or some other person designated by him may direct the investments of the trust. For purposes of the bank trustee requirement, the term "bank" includes institutions which are subject to the banking laws of a State.

If the assets of a trust are invested solely in annuity, endowment, or life insurance contracts of a life insurance company, the requirement that the trustee be a bank does not apply if the life insurance company supplies appropriate information to the Treasury Department regarding trust transactions. Moreover, while life insurance contracts may fund a qualified retirement trust, no deduction is permitted for the portion of the premium which is allocable to life insurance protection (secs. 404(a)(8), 404(e)(3)).

There are no restrictions on the type of trust investments which may be made under the new statute except that the trust may not engage in certain prohibited transactions with the self-employed person (sec. 503(j)).

B. *Custodian account.*—In lieu of a trust, a custodian account in a bank is permitted if the investments of pension funds are made solely in annuity, endowment, or life insurance contracts issued by a life insurance company, or solely in stock of an open-end regulated investment company (sec. 401(f)).

C. *Annuity plans, face amount certificates, etc.*—The retirement plan may be funded through the purchase of annuity contracts (including variable annuities) directly from a life insurance company or through the purchase of face amount certificates directly from a company which issues such certificates.

It is required under the new statute that annuity contracts (including face amount certificates) issued after 1962 be nontransferable unless the owner of the contract is the trustee of a qualified retirement trust (sec. 401(g)).

D. *Bond purchase plans.*—Retirement plans may also be funded through the purchase of a new series of Government bonds which are authorized by the new law (sec. 405). The new bonds must be purchased in the name of the individual employees (including self-employed individuals) on whose behalf they are purchased and must be nontransferable. Moreover, these bonds may not be redeemed until the named beneficiary attains the age 59½, except in the case of his earlier disability or death. The investment yield on these new bonds is not specified in the new statute, but will be fixed under the provisions of the Second Liberty Bond Act and may not exceed 4¼ percent per year.

E. *Pooled investments.*—Self-employed individuals establishing qualified plans for themselves, or for themselves and their employees, could, if they chose to do so, use associations to pool the funds of their separate qualified plans for investment purposes.

Estate and gift tax exclusions

Neither the estate tax exclusion of section 2039(c) of the Internal Revenue Code nor the gift tax exclusion of section 2517 is applicable to the portion of a decedent's interest in a qualified plan which is attributable to contributions on behalf of an individual while he was a self-employed individual. However, the estate and gift tax exclusions will continue to apply with respect to any employer contributions made while the individual was not a self-employed person.

Lump-sum distributions

Self-employed individuals are not to qualify for capital gains tax treatment in the case of lump-sum withdrawals of their entire interest in a qualified retirement plan. Rather, a special averaging provision applies under which the tax on a lump-sum withdrawal by a self-employed individual is to be the greater of the tax resulting from (*a*) including 20 percent of the lump-sum in taxable income for the current year and multiplying the resulting increase in tax by five, or (*b*) (if there would otherwise be no taxable income in the year of the lump-sum withdrawal) treating 20 percent of the lump-sum distribution, after deducting personal exemptions, as taxable income and multiplying the resulting tax by five (secs. 72(n), 402(a)(2), 403(a)(2), 403(a)(3)).

Excess contributions

The new statute provides certain penalties where excess contributions are made under a pension plan on behalf of an owner-employee.

Generally, an excess contribution is an amount greater than the total of (1) allowable contributions, upon which the deductible amount is based, and (2) permitted voluntary contributions which in no case are deductible (sec. 401(*e*). For example, an amount which exceeds the 10 percent-$2,500 limit is an excess contribution if the plan is not a contributory plan. Or in the case of a contributory plan, if voluntary contribution of 6 percent for example, may be made and the owner-employee actually contributes (on a voluntary basis) 7 percent of his earned income, he has made an excess contribution.

Such an excess contribution must be returned to the owner-employee on whose behalf it was made, together with income earned on the excess contribution (sec. 401(d)(8)). If an excess contribution is not repaid within 6 months after notification has been received that the contribution was excessive, the plan is temporarily disqualified (until the excess is returned) with regard to the person on whose behalf the excess contribution was made. Where an excess contribution is willfully made, however, the entire interest of the individual on whose behalf it was made in all plans in which he participated as an owner-employee (including the corpus allocated to his account) is required to be distributed to him (and subjected to a 110 percent penalty tax) and he is further disqualified from participating in any pension plans as an owner-employee for a 5-year period (secs. 72(m), 401(d)(5), 401(d)(8), 401(e)(2)(E)).

An exception to the foregoing rules permits an owner-employee (but not a self-employed individual who is not an owner-employee) to purchase annuity or life insurance or endowment policies from an insurance company at level premiums without fear of making an excess contribution (sec. 401(e)(3)). Under this exception, an owner-employee would be permitted to contribute each year toward the purchase price of his policy up to an amount equal to the amount he would have been allowed to contribute on the basis of his average earned income for 3 years preceding purchase of the policy. Thus, for example, if an owner-employee who has earned income of $10,000 per year for a 3-year period contracts for a life insurance policy on his own life, and the annual premium thereon is $1,000, he may continue to contribute the amount of the premium annually even though his earned income falls below $10,000. However, amounts contributed under this exception will be deductible only to the extent that they are related to earned income for the taxable year. Moreover, this exception is limited so that under no circumstances could the owner-employee obtain under one or more retirement plans level-premium policies requiring annual payments of more than $2,500. If he does so, he forfeits the benefits of this exception and the entire amount of the premiums in excess of 10 percent of earned income (not merely the amount in excess of $2,500) would be subject to the excess contribution rules.

Miscellaneous

The new law also provides that self-employed individuals will qualify for the retirement-income credit with respect to distributions from qualified retirement plans (sec. 37(c)(1)(A)). However, self-employed persons are not permitted to qualify either for the $5,000 death-benefit exclusion or for the sick-pay exclusion (secs. 101(b), 105). A self-employed individual may exclude from his gross income under

section 104 of the code amounts received through accident or health insurance for personal injuries or sickness, to the extent that such amounts are attributable to his own nondeductible contributions.

The deduction for contributions made to a retirement plan by a self-employed individual on his own behalf may not be used to create or increase a net operating loss for income tax purposes (sec. 172(d)(4)).

Moreover, owners of unincorporated businesses which elect to be taxed as corporations may participate in qualified retirement plans only in their capacity as self-employed persons (sec. 1361(d)).

APPENDIX

In summary, retirement plans covering owner-employees must meet the following requirements or qualifications in addition to those which present law requires of all retirement plans:

(1) If it is a trusteed plan, the trustee must be a bank or similar institution with fiduciary powers, but another person (who may be the employer) may be given power to control investments of the trust fund (sec. 401(d)(1)).

(2) In the case of owner-employees, benefits may not be payable before the owner-employee reaches age 59½, except in the case of severe disability or death, and benefit payments must begin before he reaches age 70½; in the case of self-employed individuals other than owner-employees, and employees of self-employed individuals benefits must be payable at age 70½ or retirement whichever is later (secs. 401(a)(9), 401(d)(4)). Benefits in the foregoing cases may, under regulations, be payable over a period no longer than the life expectancy of the employee (including owner-employees) or the life expectancy of the employee and his spouse.

(3) In the case of plans of owner-employees with employees, contributions for employees must be nonforfeitable at the time they are made (sec. 401(d)(2)).

(4) In the case of a profit-sharing plan, a definite formula for determining employee contributions must be provided (sec. 401(d)(2)).

(5) Plans covering owner-employees must provide contributions for each full-time employee who has 3 years of employment (sec. 401 (d)(3)).

(6) An owner-employee must consent to be covered by the plan (sec. 401(d)(4)).

(7) No excess contribution may be made (sec. 401(d)(5)).

(8) Where an owner-employee has employees, the plan may be coordinated with social security (under special rules) only if allowable contributions for him are not more than one-third of the total contributions made under the plan (sec. 401(d)(6)).

(9) If an owner-employee dies, his entire interest must within 5 years be (*a*) distributed to designated beneficiaries, (*b*) used to provide immediate annuities for them, or (*c*) paid out, under a plan of distribution already commenced, to a beneficiary over the life expectancy of the owner-employee or over the joint life expectancy of the owner-employee and his spouse (sec. 401(d)(7)).

(10) Excess contributions, if made, must be returned to the person who made them, and income earned by the plan which is attributable to the interest of an owner-employee with respect to whom an excess contribution was not timely returned must be taxed to the owner-employee (sec. 401(d)(8)).

(11) For purposes of qualifying the plan and determining what limitations are applied to contributions for owner-employees, two or

more businesses controlled by an owner-employee or by a group of owner-employees must be considered as a single business (secs. 401 (d)(9), 401(d)(10)).

(12) Contributions on behalf of any owner-employee must be determined on the basis of his earned income from the trade or business with respect to which the retirement plan is established (sec. 401(d) (11)).

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